Forex and Interest Rate Outlook

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AIB Treasury Economic Research Unit

- **Bank of England eases policy aggressively to help mitigate the negative impact on the UK economy of the vote to leave the EU. Another BoE rate cut likely in coming months**
- **Sterling falls sharply on Brexit vote and appears set to decline even further given likely weakening of economy, further BoE easing and the difficult Brexit negotiations ahead**
- **Ample liquidity, further monetary easing by central banks and a sharp drop in bond yields see stock markets rebound strongly following their sell-off on Brexit vote**
- **Fed reluctant to tighten policy with divided views within FOMC. US rates, though, likely be hiked before year-end as labour market remains strong and economy regains momentum**
- **Dollar should strengthen as US rate hike comes back onto the agenda in the months ahead**

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Global Economic Outlook

Global economy expected to withstand Brexit vote shock

The global economy continues to struggle for upward momentum, with growth very much underperforming. The OECD in its mid-year Economic Outlook stated that "eight years after the financial crisis, the global recovery remains disappointingly weak". World growth was just over 3% in 2015, the weakest rate since the end of the economic crisis of 2008-2009, reflecting in particular slower growth in emerging economies. A similarly subdued growth rate of around 3% is being forecast by both the IMF and OECD for the world economy in 2016.

The IMF in its July 2016 World Economic Update noted that growth in most advanced economies remains lacklustre. However, the recovery in advanced economies has gained some momentum in recent years, with GDP growth picking up to close on 2% in 2014-15 from 1.2% in 2012-13. This is despite a marked slowdown in growth in emerging economies. The improved performance is largely attributable to a strengthening of activity in the Eurozone. Meanwhile, growth in the US and UK has remained solid in the past few years. However, Japanese growth remains erratic and weak, despite an ultra-loose monetary policy and a big decline in the yen in 2014/15. Both the IMF and OECD see growth being sustained at close to 2% in advanced economies in 2016 and 2017, helped by a continued loosening of monetary policy and less restrictive fiscal stance.

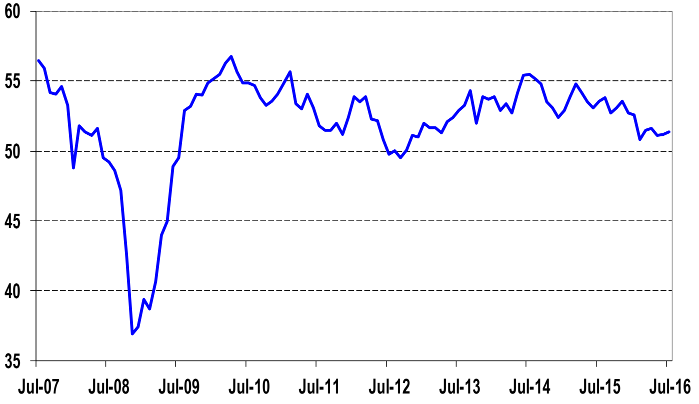
Meanwhile, growth in emerging economies has lost considerable momentum and is estimated by the IMF at 4% in 2015, down from 4.7% in 2014 and 5% in 2013. In fact, the trend has been one of weakening growth in emerging economies since 2010, when it stood at 7.5%. Most notably, GDP growth in China slowed from 10.4% in 2010 to 6.9% in 2015. The impact of the slowdown in China on other emerging economies, combined with a sharp fall in commodity prices has been greater than expected, with some countries like Brazil going into recession. The IMF sees growth in emerging economies at around 4% again in 2016, before picking up to over 4.5% in 2017, helped by the modest recovery in commodity prices this year and emergence of economies like Brazil and Russia from deep recessions.

However, downside risks remain for the world economy. The Global Composite PMI has dropped to below 52 in the past few months, its lowest level in over three years. In particular, the still low level of commodity prices, high private sector debt levels, a need for sizeable fiscal tightening in some countries and reliance on capital inflows are all downside risks to the growth prospects for emerging economies.

Against this backdrop, the Brexit vote has cast a further shadow over the global economy and heralds in a period of political and economic uncertainty. There is now the added complication and uncertainty of the UK's future trade relations with the EU. A marked deceleration in the growth rate of the UK economy is expected over the next couple of years. Estimates from the Bank of England and NIESR suggest that UK growth could be 2.5% lower by end 2018 as a result of the vote for Brexit. Growth in the Eurozone is also likely to be somewhat lower.

The IMF estimated in its July Economic Update that the Brexit vote could knock 0.2% off global growth in 2016 and 2017. However, this is being partially offset by a better than expected performance by emerging economies this year. As a result, it shaved just 0.1% off its global growth forecasts for 2016 and 2017. It now sees world output growing by 3.4% next year, while the OECD is forecasting 3.3% growth. The IMF highlights, though, that this is based on the benign assumption of a gradual reduction in Brexit related uncertainty going forward, with no financial market disruption and the UK and EU avoiding the creation of large economic and trade barriers.

Global Composite PMI (JP Morgan)



Source: Thomson Datastream

GDP (Vol % Change)

	2014	2015	2016 (f)	2017 (f)
World	3.4	3.1	3.1	3.4
OECD Economies	1.9	1.9	1.8	1.8
US	2.4	2.4	2.2	2.5
Eurozone	0.9	1.6	1.6	1.4
UK	3.0	2.2	1.7	1.3
Japan	0.0	0.5	0.3	0.1
Non-OECD Economies	4.6	4.0	4.1	4.6
China	7.3	6.9	6.6	6.2
India	7.2	7.6	7.4	7.4
World Trade Growth (%)	3.7	2.6	2.7	3.9
OECD Economies Inflation (%)	1.4	0.3	0.7	1.6

Source: IMF World Economic Outlook Update, July 2016

Interest Rate Outlook

Brexit vote leads to further monetary easing

The past couple of years have been characterised by a widespread loosening of monetary policy in many countries and a scaling back of rate hike expectations in economies where policy tightening had been expected to commence. This pattern has continued in 2016. The Bank of Japan stunned markets in January by unexpectedly cutting rates, moving them into negative territory. The ECB eased policy further at its March meeting, lowering the deposit rate by a further 10bps to −0.4%, while cutting the refi rate by 5bps to 0% and expanding QE. The Bank of China has also loosened policy further this year, while the Reserve Banks of Australia and New Zealand have also cut rates. The Bank of England has become the latest central bank to ease policy. Meanwhile, the expected rate hikes from the US Fed this year have so far failed to materialise.

The outcome of the UK's EU referendum has had a major impact on interest rate markets. The vote in favour of Brexit saw markets become even more dovish on interest rates over the next 2-3 years, with bond yields falling sharply. We had already seen big downward shifts in futures curves during the first half of 2016 and this downward move received added impetus from the referendum result. Many of the world's main central banks have a clear easing bias and are expected to loosen policy further in the coming months.

The BoE announced significant policy easing measures at its August meeting to help mitigate some of the negative effects on the economy of the vote for Brexit. It cut the Bank rate by 25bps to 0.25% and expanded its QE programme. It also indicated that it is likely to reduce rates again later this year if the economy weakens in line with its expectations in the aftermath of the referendum vote. It highlighted its wish, though, to keep the Bank rate positive so the next rate cut is likely to be around 15bps, taking the official rate down to 0.1%. The BoE also pointed out that it had other policy instruments it could use if more easing is required.

From an ECB perspective, the Central Bank retains an easing bias and it also has indicated that it would ease policy again if required. The euro has strengthened in the aftermath of the Brexit vote, which will make it even more difficult to get inflation back to its 2% target. At its July meeting, the ECB noted that underlying price pressures continue to lack a convincing upward trend. Thus, it would not be a surprise if the ECB reduced its deposit rate by another 10bps, bringing it to −0.5%. This could well materialise at the September Council meeting. Further out, the market expects Eurozone rates to remain very low for a long period of time. Futures pricing suggests that three month money rates will remain negative in the Eurozone until 2021.

Meantime, after raising rates by 25bps to 0.375% at its December 2015 meeting, the first such rate hike in nearly a decade, the US Federal Reserve has refrained from any further rate hikes since then. This has been in part due to financial market volatility and some unexpected softness in the US economy in H1 2016. However, the Fed retains a tightening bias. Its June FOMC projections indicated that it expected to raise rates by 50bps in total during the second half of this year to be followed by three 25bps hikes in both 2017 and 2018. This would bring the Fed funds rate to 2.375% by end 2018.

Markets, though, are quite sceptical and do not expect a rate hike until mid-2017 and do not see another rate increase after that until early in 2019. However, senior Fed officials have warned markets that they have become too dovish on US rate hike expectations in 2016. We expect the Fed will hike rates later this year if the US economy regains momentum as expected in the second half of 2016.

US Interest Rate Forecasts (to end quarter)

	Fed Funds	3 Mth	1 Year	2 Year *	5 Year *
Current	0.375	0.83	1.53	0.99	1.15
Sept '16	0.375	0.85	1.55	1.00	1.20
Dec '16	0.625	1.05	1.75	1.30	1.45
Mar '17	0.625	1.05	1.80	1.40	1.50

** Swap Forecasts Beyond 1 Year*

Eurozone Interest Rate Forecasts (to end quarter)

	Deposit Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	-0.40	-0.32	-0.07	-0.21	-0.13
Sept '16	-0.50	-0.40	-0.10	-0.25	-0.15
Dec '16	-0.50	-0.40	-0.10	-0.25	-0.15
Mar '17	-0.50	-0.40	-0.10	-0.25	-0.15

** Swap Forecasts Beyond 1 Year*

UK Interest Rate Forecasts (to end quarter)

	Repo Rate	3 Mth	1 Year	2 Year *	5 Year *
Current	0.25	0.39	0.73	0.42	0.49
Sept '16	0.25	0.35	0.70	0.40	0.50
Dec '16	0.10	0.20	0.60	0.40	0.50
Mar '17	0.10	0.20	0.60	0.40	0.50

** Swap Forecasts Beyond 1 Year*

Current Rates Sourced From Reuters, Forecasts AIB ERU

Forex Market Outlook

Fed's lack of action on rate hikes weighs on the dollar

Apart from sterling weakness, the other notable feature of currency markets recently has been the softer tone to the dollar. This is reflected in EUR/USD trading up around $1.13 and USD/JPY testing below ¥100. Meanwhile, currencies like the Australian and New Zealand dollars have made significant gains against the dollar over the summer, despite their Central Banks cutting interest rates. Even the under pressure UK currency has managed to hold its own against the dollar since early July.

The dollar has been weighed down by evapourating expectations that the Federal Reserve will hike US rates anytime soon. The minutes from the Fed's July meeting were somewhat less hawkish then had been expected. The text of the discussion indicated that there was no clear consensus within the FOMC on the issue of when to hike interest rates, suggesting the Fed is in no hurry to do so. Markets are currently not expecting a rate increase from the Fed until mid-2017 and do not foresee another rate hike after that until early 2019. At the start of 2016, the market was pricing in two rate hikes by the end of this year alone.

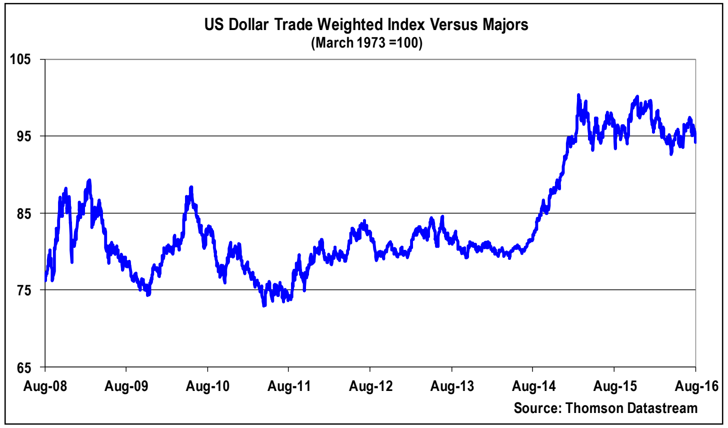
Nonetheless, a number of key Fed officials have warned markets that they are underestimating the chances of US rate hikes this year. Furthermore, the Fed's own interest rate projections show that it has a clear bias towards tightening policy, with the latest forecasts from June pointing to two 25bps hikes in the second half of this year. This is hardly surprising given that the Fed expects the US economy to regain momentum in H2 2016, while the unemployment rate has dropped below 5%.

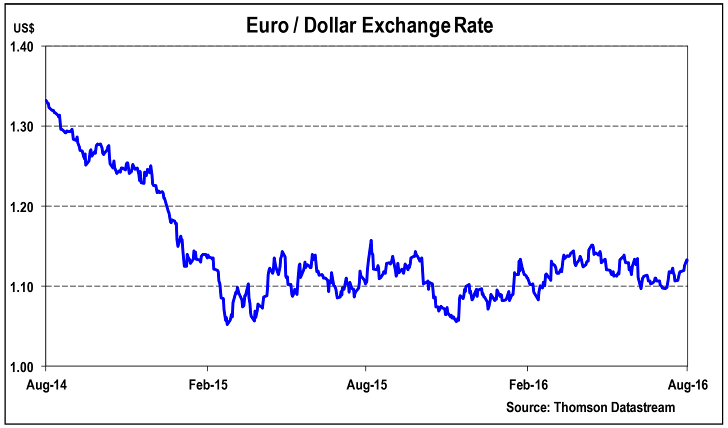
There are three Fed policy meetings to come over the remainder of the year, in September, November and December. Our view is that December is the mostly likely timing for a rate hike. By then, the Fed will be able to assess if the recent strong run of labour market data is being sustained and whether the economy regained momentum in the second half of 2016. Most recent data releases point to good US growth so we expect the Fed will hike rates towards year end, providing a modest fillip for the dollar.

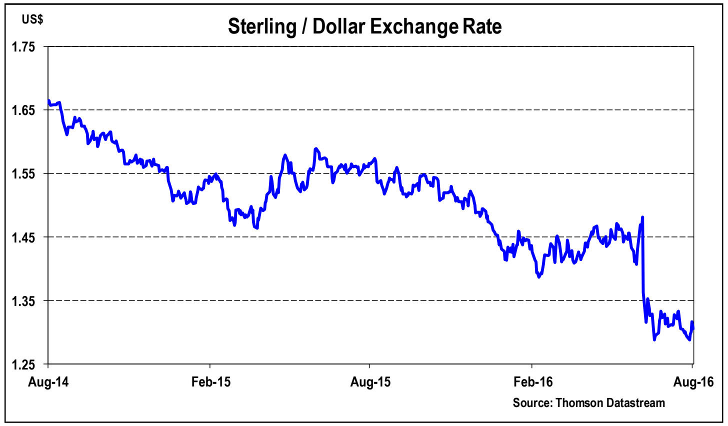
Meanwhile, the euro continues to face some challenges. The combination of Brexit uncertainty and the associated risks for the EU, as well as a sluggish Eurozone economy are headwinds for the currency. There is also the potential for further ECB easing, with the possibility of the depo rate being cut by 10bps to −0.5%, as well as an extension to the QE programme. This could put downward pressure on the currency.

Overall, though, we do not expect a breakout from the $1.06-1.16 trading range that has been evident for EUR/USD since early 2015. Any rate moves by the Fed or ECB are likely to be modest. Thus, we expect the EUR/USD pair to continue to trade in its recent range of $1.10-1.15 in the coming weeks but to test the bottom of this range if, as we think likely, a US rate hike starts to materialise near year end.

Elsewhere, a combination of risk aversion and market uncertainty has provided strong safe haven support for the yen this year. The dollar has fallen from ¥120 to ¥100, with the euro declining from ¥130 to ¥113 since the start of 2016, despite policy easing by the BoJ. It is hard to argue for further gains by the yen given the weakness of the Japanese economy and prospect of further easing by the BoJ. Thus, we would not be surprised if the strong rally by the yen soon runs out of steam, with the dollar/yen rate settling around the 100 level.







Sterling plummets on Brexit vote and is vulnerable to further falls

Sterling appreciated by nearly 20% on a trade-weighted basis between 2013 and mid-2015, partly fuelled by expectations of UK rate hikes. It may also have been helped by dollar strength over this period with expectations of Fed rate hikes driving the US currency higher too. GBP/USD was fairly range bound during this time.

The euro fell from close to 90p versus sterling in 2011 to 80p in 2014 and a 70-74p trading range in 2015. These gains, though, have largely unwound this year because of concerns over Brexit. Sterling weakened during the first half of the year in the run-up to the referendum vote on June 23rd. The euro rose by some 10% against sterling, climbing from 70p in late 2015 to around the 78p level. GBP/USD also fell from a high of $1.59 last summer, to a $1.40-1.46 trading range ahead of the vote. In the days leading up to the referendum vote though, markets concerns eased somewhat and they moved to price in a 'remain' win. This saw GBP/USD trade back up towards $1.50 and EUR/GBP back down near 76p.

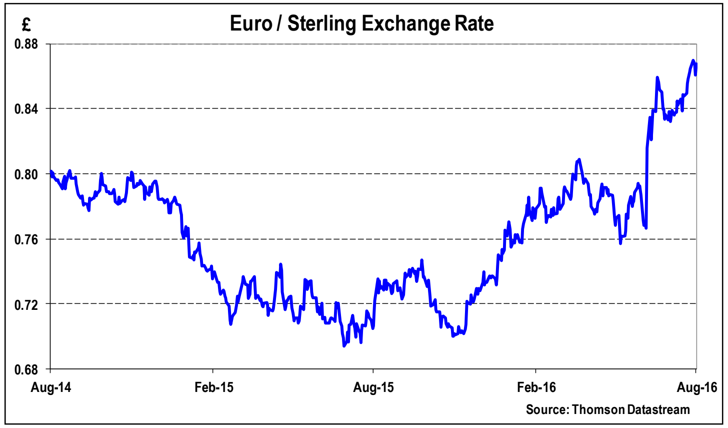
When the actual count showed the 'leave' side winning, sterling went into sharp decline. The currency fell by some 14% against the dollar, falling through the key resistance level at $1.37-1.38 and plummeting to 30-year lows below $1.30 by early July. Cable has remained quite range-bound since then, trading between $1.29 and $1.33. Sterling's post referendum weakness also greatly impacted EUR/GBP, with the pair initially trading as high as 86p before moving into an 83-85p range. More recently, the euro made fresh gains on BoE policy easing. It hit new three year highs above the 87p level in mid-August.

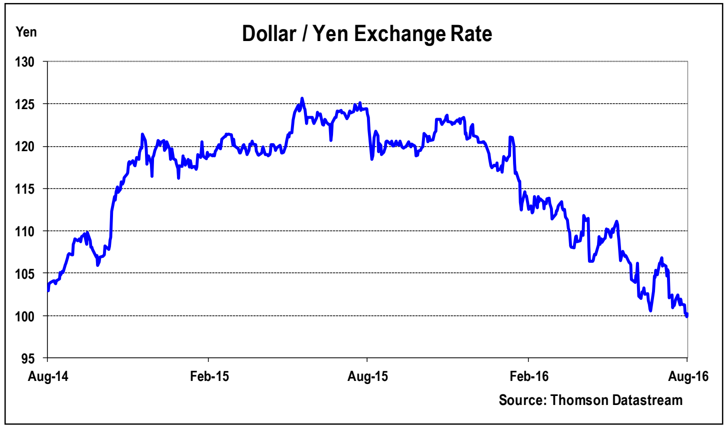
The referendum outcome and the uncertainty associated with it, are serious headwinds for the UK's economic outlook and sterling. The UK has yet to trigger Article 50 of the Treaty on European Union to start the official exit process. Current indications are that this may not happen until the end of this year at the earliest. The EU Treaty then provides for a two year period for the negotiations on an EU exit. A central part of these negotiations is likely be the future trading relationship between the EU and the UK.

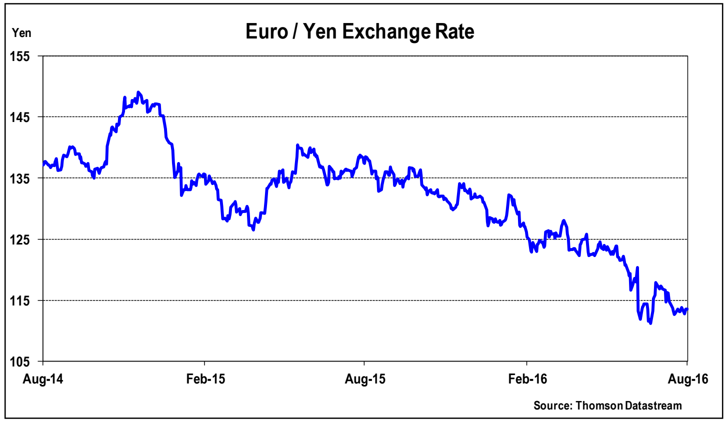
The outcome of these trade discussions will ultimately determine the long run implications of Brexit for the UK economy. Over the next couple of years, though, there will be no change to the institutional framework that governs the UK's relationship with the EU. However, the uncertainty over Brexit will weigh on economic activity.

Sterling is vulnerable to further downside against the backdrop of a likely slowdown in the UK economy, more BoE policy easing and continuing uncertainty. Survey data show a marked weakening of business sentiment and consumer confidence in the aftermath of the Brexit vote. The uncertainty about the economic outlook could drag on for at least a couple of years as the EU exit negotiations are likely to be difficult and prolonged.

Sterling could trade as low as $1.25 against the dollar before the end of the year. Further out, the GBP/USD pair could move even lower, declining below $1.20 if UK relations with the EU become fraught and there are a lot of difficulties in reaching some form of trade deal. The EUR/GBP cross is likely to continue to move higher. The pair is trading around the 86-87p level at present and the euro could rise to 88p or above by year end. Looking further ahead, the pair may well climb to its 2011 high of 90p if the negotiations with the EU prove very difficult. Overall then, while sterling has fallen a long way, the risks remain to the downside for the UK currency.



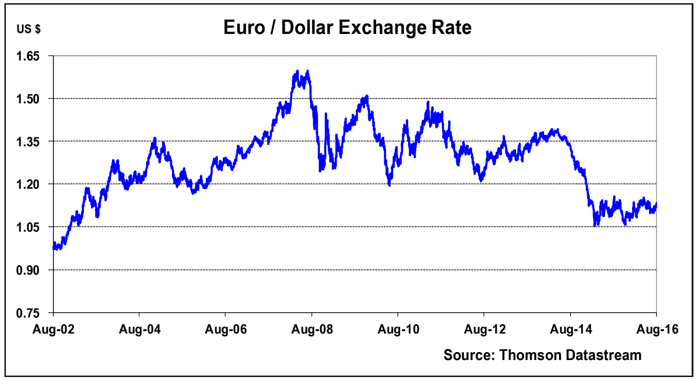


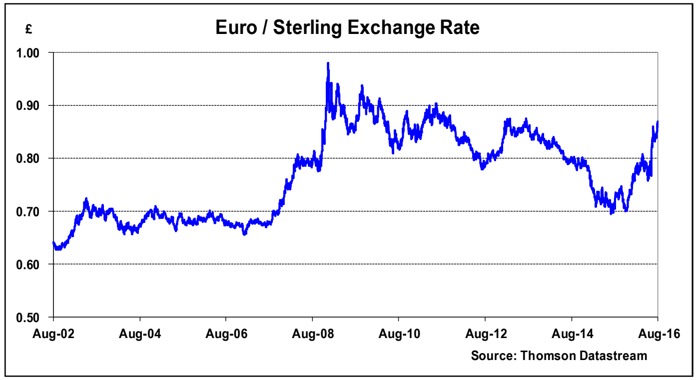


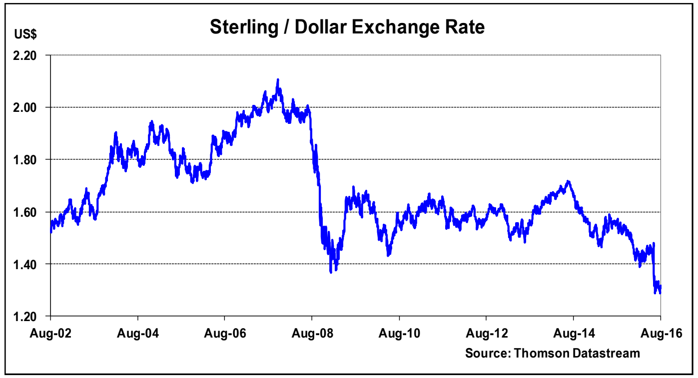
Summary of Exchange Rate Forecasts

("Spot" Forecasts for end Quarter can be taken as Mid-Point of expected Trading Range)

	Current	Q3-2016	Q4-2016	Q1-2017	Q2-2017
Euro Versus					
USD	1.133	1.09-1.15	1.07-1.13	1.06-1.12	1.05-1.11
GBP	0.860	0.84-0.90	0.85-0.91	0.86-0.92	0.87-0.93
JPY	113.48	109-115	107-113	106-112	105-111
CHF	1.09	1.09	1.09	1.08	1.08
US Dollar Versus					
JPY	100.17	97-103	97-103	97-103	97-103
GBP	1.318	1.25-1.33	1.22-1.28	1.19-1.25	1.17-1.23
CAD	1.29	1.29	1.28	1.27	1.26
AUD	0.76	0.76	0.77	0.78	0.79
NZD	0.73	0.73	0.74	0.75	0.76
CNY	6.64	6.66	6.69	6.72	6.75
Sterling Versus					
JPY	132	129	125	122	120
CAD	1.70	1.66	1.60	1.56	1.51
AUD	1.73	1.70	1.62	1.56	1.52
NZD	1.80	1.77	1.69	1.63	1.58







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